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NOTES

THE VALUATION OF PUBLIC UTILITIES IN CONNECTION WITH CONFISCATORY RATES.—Should a public utility be allowed to charge rates sufficient to yield a fair return even in the worst years, or only in normal years? What weight shall be given to the company's own statement of operating expenses? Upon what rate-base shall the company be allowed to earn a fair return? These three questions are discussed by Mr. Justice Greenbaum of the New York Supreme Court, Special Term, Part IV, in the recent case of *Kings County Lighting Co.* v. *Lewis* (1920) 180 N. Y. Supp. 570. The court dismissed the company's complaint in an action to declare null and void the statute of 1916 fixing the price of gas in the company's territory at 80¢ per 1,000 cubic feet. The complaint was dismissed "without prejudice, however, to reopen the case by appropriate proceedings, if, after an adequate experimentation under an 80-cent rate, it [the company] believes that it can prove that this rate is confiscatory, as to it."

The court admits that the company has shown the return for 1918 to be inadequate, due to the abnormally high cost of coal and gas oil, but

holds this fact not conclusive as to the question of confiscation. When conditions are as abnormal as those of 1918, that question must be judged by a consideration of the average of gains and losses over a period longer than a year.

The company, however, contended that even in 1916 and 1917 the returns under an 80¢ rate would be inadequate. For these years the court refused to accept the company's figures of operating expenses at their face value. It deducted items aggregating a considerable sum, thus correspondingly raising the figures for the return under the 80¢ rate. The greater part of this alteration was made, not because the court found the expenses in question definitely unreasonable, but because they were sufficiently questionable to require from the company some affirmative justification, which was not forthcoming. The decision on this point rested on the familiar proposition, so often expressed and so seldom acted upon by the courts, that the burden of proving confiscation rests on the company.

On the more important question of what it is upon which the rates must yield a fair return, the court was not obliged to make any actual decision. It gave utterance, however, to several *dicta* and suggested several interesting points. As a preliminary statement of the main issues met with in valuations we find the following:—

"The plaintiff contends that the present reproduction cost forms the proper basis of valuation of its plant. The defendant the City of New York insists that the actual original cost of its properties must control. The defendant Public Service Commission claims that the value should be reached upon the consideration of all the relevant facts. The rule now seemingly recognized by the courts is that the fair present value of the property is the basis upon which a fair return should be paid."

The court cites Mr. Justice Harlan's famous *dictum* in *Smyth* v. *Ames*[1] and some of the numerous clouds of mist generated by that original fog-bank. It adds:—

"In other words, the just or fair compensation to which a public utility is entitled must be based upon 'the fair return upon the reasonable value of the property at the time it is being used for the public.'" (Citing *San Diego Land & Town Co.* v. *National City* (1899) 174 U. S. 739, 757, 19 Sup. Ct. 804.)

By this language the court seems to sustain the contention of the Public Service Commission, already stated. Presumably, then, reproduction cost is to be considered only insofar as it throws light on "present value". As to original cost, the court is more explicit. "Under the authorities", it says, "the original cost of construction is a relevant fact to be considered in arriving at its present value." But the succeeding language of the court seems to contradict this position. It goes on to say, "In this connection, however, it is instructive to consider the statutes on this subject". After pointing out the fact that the provision of the Public Service Law regarding gas companies, unlike that regarding common carriers, still contains the words "a reasonable average return upon the capital actually expended", the judge says:—

"The policy of the state with reference to gas companies has thus been and still appears to be that the money actually expended by investors for construction purposes shall form the basis of measuring their right to a return upon their capital."

[1](1898) 169 U. S. 466, 546, 18 Sup. Ct. 418.

Now it is a very different thing to say that the money actually spent is itself the basis on which the company is entitled to a fair return, and to say that the money actually spent is a "relevant fact" in arriving at the "present value". Actual cost may on occasion be the best available evidence of reproduction cost, and so of present value (just as last year's election returns may be evidence of how the votes will be cast this year); but actual cost is not the same fact as present value. Wherever there is reason to believe that present value differs in amount from actual cost, then to base a fair return on present value is one policy, to base it on actual cost a totally different one. The object of the former is to preserve intact the existing value of whatever portion of the property is included in the valuation; the object of the latter is to keep the net earnings sufficiently high to attract capital and no higher. Mr. Justice Greenbaum therefore rides two horses—the policy of the courts to base the return on "present value", and that of the state to base it on actual cost. However, we soon find him with both feet on the "present value" horse. Immediately after the language last quoted as to the state's policy, he says:—

> "The court has, nevertheless, proceeded to appraise the value of the plaintiff's properties upon what it has deemed from all the evidence to be the present value of the plant, in view of the rule now generally recognized by the courts."

This relinquishment of the "actual cost" horse does not necessarily indicates a definite rejection of the state's policy regarding gas companies, but rather, perhaps, a demonstration that in this particular case even the "present value" horse will fail to bring him to the company's goal. The "present value" finally obtained, as he points out, "is close to the estimate given by Mr. Adams [the City's expert] as original cost without depreciation."

Three questions now present themselves to us, namely: *First,* in cases where it makes a difference, would it be proper to reject actual cost in favor of present value in a gas case in New York? *Second,* if the actual cost be taken, how should "going value" and "depreciation" be treated? *Third,* if the present value basis be taken, how should it be estimated?

Let us take up these questions in inverse order, and first see how the court answers the last one. It values the property in three parts—"going value", plant apart from land, and land. In the case of the land, it estimates the present market value for other purposes, which is of course what the company would have to pay were it to buy the land now—the reproduction cost. For the plant apart from the land it sets down two sets of reproduction cost figures, and two sets of actual cost figures, then criticises one of the former sets for failing to deduct depreciation, and adds:—"Considering all the various sources from which one is enabled to derive information as to the fair reproduction cost of the plaintiff's plant . . . the court is of opinion that its value as of December, 1916, will be fairly measured by the sum of $2,350,000 . . ." This, be it noted, is not an attempt to reach some mysterious "composite value" by "considering" this, that and the other unrelated item; it is apparently an attempt to find one definite fact, the cost of reproduction less depreciation. One set of reproduction cost figures, however, the court refuses to consider, namely those indicating what it would cost to build in 1917 at the abnormal war prices

of that year. For this rejection it cites ex-Justice Hughes's opinion as referee in *Brooklyn Borough Gas Co.* v. *Public Service Commission.*[2]

As to "going value", the court finds that the company has failed to sustain the burden of showing that there was any. The company's expert was not allowed to testify to hypothetical deficits which would be incurred in reproducing a plant like the company's, on the ground that evidence concerning deficits actually incurred was obtainable. It was on this ground that the case was distinguished from *Kings County Lighting Co* v. *Willcox,*[3] where evidence of hypothetical deficits was admitted. Furthermore, from an examination of the company's financial history, the court was convinced that whatever early deficits may in fact have been incurred must have been amply recouped from earnings. In applying this recoupment theory it followed Mr. Justice Day's ruling in *Des Moines Gas Co.* v. *Des Moines,*[4] to the effect that "it is not to be presumed, without proof, that a company is under the necessity of making up losses and expenditures incidental to the experimental state of its business."

In this discussion of "going value" the court has again unconsciously put both feet on the "actual cost" horse. The physical property of the plant (if the earning-capacity value of the entire business is sufficiently great) is equivalent to what it would cost the company if it did not already own the property; that cost would include hypothetical losses. These losses might be less than the actual ones by reason of the fact that when the actual ones were incurred the community's desire and need for gas was doubtless less than at present. On the other hand, there would be no offsetting surpluses. The question is how much the company is saved by virtue of the fact that it now owns the physical property. It is saved, of course, precisely what it would lose did it not own it already. Whatever surpluses the company might ultimately receive were it required to acquire its property now for the first time are surpluses which it will receive in the actual state of affairs anyway. The losses involved in building up the property will not be incurred in the actual state of things. While the company's expert might find difficulty in showing that in a hypothetical plant there would be any losses at all once the plant were ready to do business, nevertheless the court's grounds for rejecting the evidence were inconsistent with the "present value" theory.

The treatment of land and plant calls for no particular comment, except the rejection of the cost of reproducing the plant at the abnormal prices of 1917. If the earning-capacity value was greater, it might be supposed at first sight that the company would in 1917 pay even the 1917 cost of reproduction if it did not already own the plant; the fact of ownership saved the company from precisely that cost. This would be true if the company expected the 1917 prices to continue. If it expected a reduction, however, in the near future, it is conceivable that the company might count on losing less by postponing earnings for a year or two than by building at a less economical cost than necessary. In that case, it would not buy at all in 1917; the physical property would have no exchange value for that year.

So much for the measurement of present value. If we were pursuing the "actual cost" rather than the "present value" theory, how should we treat "going value" and "depreciation"? Early deficits—or later ones,

[2](1918) 17 N. Y. State Dept. 81, 98, 99.

[3](1914) 210 N. Y. 479, 104 N. E. 911.

[4](1915) 238 U. S. 153, 165, 35 Sup. Ct. 811.

for that matter—are as much part of the cost of the plant as anything else. It seems logical to include them in the amount on which a return is based for succeeding years. On the other hand, it seems equally logical, *on the actual cost policy,* to deduct any surpluses above a fair return, unless they have gone back into the plant. This the court in the present case, like the United States Supreme Court in the *Des Moines Gas* case, specifically holds regarding the costs of building up the business. As those costs are no different in principle from any other costs, there is no reason for failing to deduct surpluses even when they *more* than offset the deficits. This the courts and commissions, however, do not seem inclined to do, even when apparently riding the "actual cost" horse. The reason probably is that they think of surpluses as affecting only that particular cost to which they have given the misleading name of "going value". When pursuing the actual cost policy they will apparently reduce the rate base below the original cost (where reasonably incurred) only in case the company has accumulated funds for depreciation which it has diverted to dividends. In such cases they frequently denominate the reduction below original cost, "depreciation". This is because they do not feel quite secure on the "actual cost" horse and instinctively use language more appropriate to the other animal. Depreciation obviously means shrinkage in value, not in cost. But with the Supreme Court uncertain which horse it is riding, who can blame the inferior courts and commissions for a similar confusion?

We come now to the question whether the actual cost policy of the New York statute regarding gas companies is constitutional. The legislature cannot, any more than the commission, constitutionally deprive a company of a "fair return on the fair value". If that means the *existing* value, a return on less than this will not be approved merely because it constitutes a fair return on actual cost. If, however, the legislative policy be enunciated before investments are made, and enunciated in such a way as to carry conviction to investors that the policy will be carried out, then the value of the physical property (or even of the physical property plus all intangibles) never will exceed the actual cost. No one will pay for such a property more than the amount on which a fair return is expected. In such a case, a return on actual cost would be at the same time a return on present value, and would therefore be constitutional. To give a warning of the convincing character necessary for this purpose, however, would require either a 100% tax on any chance earnings in excess of the announced return, or else a logical deduction of all such surpluses from the rate-base for succeeding years, as well as an addition thereto of deficits. Since this is not the course now pursued, the statutory actual cost policy may perhaps be held to be unconstitutional.

The reasoning of the last paragraph, however, is based on one assumption, namely that the Supreme Court insists on a fair return on the *exchange value* of something, and that something must, in consistency, exclude at least part of the non-physical or intangible element of the property. Such an assumption is more in harmony with the Supreme Court's opinions than any other rational assumption. Yet there are sufficient inharmonious *dicta,* and the concept of physical value is itself sufficiently artificial, to render it extremely questionable whether the Supreme Court's opinions on this subject are in harmony with *any* rational assumption. Whether the "actual cost" gas policy, therefore, is unconstitutional, in the sense that it would be held void

by the Supreme Court, is a question that passes the understanding of mere reason, and can be answered only by those whose faith in our institutions brings their minds into communion with the minds of those who guard our institutions.

R. L. H.

CONDEMNATION OF PROPERTY FOR THE PUBLIC WELFARE.—In a recent Minnesota case, *State ex rel. Twin City Bldg. & Inv. Co.* v. *Houghton* (Minn. 1920) 176 N. W. 159, the court upon reargument upheld as constitutional a statute designed to establish residential districts in cities of the first class. The statute provided for the restriction of property in a designated district against its use for apartment houses and contained a provision for compensation to the owners of such property by proceedings in eminent domain. Minn. Laws 1915 c. 128, Gen. Stat. Supp. (1917) §§ 1639 (10-16). The relator, who had been denied a permit to erect an apartment house on his property, brought this action contesting the constitutionality of the statute on the ground that the legislature had no power to condemn his property for this purpose, since it was not a taking for a public use.[1] The court in upholding the statute relied mainly on three arguments: (1) the legislature is presumably correct when it declares a use public; (2) provisions of this sort tend to stabilize property values, and a diminution of such values tends to reduce state and municipal taxes,—a measurable public loss; (3) the legislature has the power to take property, with compensation, for purely aesthetic purposes.[2]

It is well settled that the power of eminent domain cannot be exercised except for a "public use". Two views have grown up as to the meaning of this phrase, the one that "public use means use by the public", the other, that it is "equivalent to public benefit, utility and advantage".[3] Under the former theory it would seem impossible to sustain the instant case. As the court admits, "the public gets no

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[1]This court had decided on a previous hearing, (1919) 174 N. W. 885, against the constitutionality of the statute, on the grounds that the condemnation was neither for a public use nor a valid exercise of the police power. For a criticism of this decision see 20 Columbia Law Rev. 219.

[2]But the court indicated that were no compensation provided, it would feel bound to hold such a statute unconstitutional. For this proposition it cited Commonwealth *v.* Boston Adv. Co. (1905) 188 Mass. 348, 74 N. E. 601. In that case the court refused to uphold an ordinance prohibiting billboards on the ground that no compensation was provided and that the ordinance was not shown to be a protection of either the "public safety, health, peace, good order or morals". Hence, the statement that property may be taken for purely aesthetic purposes is mere *dictum*. It should be noted that in a recent case, Cusack Co. *v.* City of Chicago (1917) 242 U. S. 526, 37 Sup. Ct. 190, followed in St. Louis Poster Adv. Co. *v.* St. Louis (1919) 249 U. S. 269, 39 Sup. Ct. 274, the Supreme Court of the United States actually did uphold an ordinance prohibiting billboards without compensation, but on p. 530 of the *Cusack* case it was careful to state that it did so "in the interest of the safety, morality, health and decency of the community". The court in the *St. Louis* case, at p. 274, actually admitted that the interest protected was to a considerable extent aesthetic.

[3]1 Lewis, Eminent Domain (3rd ed.) §§ 257, 258. Mr. Lewis makes a strong argument for the former concept, particularly on the ground of its certainty, but the tendency of modern courts would seem to be against him.